HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

The Lord Bridges of Headley
Chair, Economic Affairs Finance Bill Sub-Committee
House of Lords
London
SW1A 0PW

1 February 2022

Dear George,

GOVERNMENT RESPONSE TO THE HOUSE OF LORDS ECONOMIC AFFAIRS FINANCE BILL SUB-COMMITTEE REPORT, 'BASIS PERIOD REFORM AND UNCERTAIN TAX TREATMENTS'.

I am pleased to attach a comprehensive Government response to the Sub-Committee's report, Basis Period Reform and Uncertain Tax Treatments, published in December 2021.

I appreciate the time and effort the Sub-Committee has spent considering these two measures, and I value the benefit of external scrutiny.

In preparing this response, the Government has carefully considered the issues that the Sub-Committee has highlighted. I am pleased to say that the Government has accepted two recommendations and partially accepted a further six recommendations. I am grateful to you and your Sub-Committee for its careful consideration and reflections on these important measures.

As you will see from the detailed response which I enclose, HMRC have already taken forward a number of actions on Uncertain Tax Treatment as a result of your report, such as committing to monitoring the regime and not legislating a third trigger without consultation.

The Government believes that the regime will help identify those businesses who pay less than they should and, where this is the case, to intervene appropriately in order to put things right.

I would also like to thank the Sub-Committee for engaging with the technical but important issue of basis period reform. As we seek to modernise the tax system, we need to make sure that our tax law supports new, digital systems for administering tax, and helps move the whole system towards timely payment of tax. This reform, which will bring in a single, consistent basis of assessment for all self-employed businesses and support the introduction of Making Tax Digital for Income Tax Self-Assessment, is a key step on the way.

Throughout the policy development process for basis period reform the Government has shown that it is willing to amend details of the design in response to stakeholder feedback. I welcome the Sub-Committee's agreement that basis period reform should continue, and I recognise that it is important to get this reform and its implementation right. As you will see in the response enclosed, HMRC will be taking forward a number of additional actions following your report.

I thank the Sub-Committee for its continued interest in this area.

Yours sincerely,

Lucy Frazer

THE RT HON LUCY FRAZER QC MP

House of Lords Economic Affairs Finance Bill Sub-Committee:

Basis Period Reform and Uncertain Tax Treatments (HL Paper 128)

Government Response

Contents

1. Introduction

The Government thanks the Committee for its report on its inquiry into Basis Period Reform and Uncertain Tax Treatment, and notes its conclusions and recommendations.

Basis period reform is an important simplification of the way the self-employed and partners allocate their profits to tax years, particularly in advance of Making Tax Digital for Income Tax (MTD) and in the context of the Government’s 10-year Tax Administration Strategy. The Government therefore welcomes the Sub-Committee's view that reform should continue.

The single, consistent tax year basis of assessment is an important step towards the vision of an effective and modern tax system, set out in the Tax Administration Strategy. Basis period reform makes the collection and use of real-time data under MTD much simpler, and makes that data much more relevant to a business’s tax bill. Removing the complexities of the current basis period rules will make tax for businesses more straightforward and harder to get wrong, and ensure that they pay the right tax.

The Government is keen to ensure that the reform is developed and implemented with feedback from businesses, accountants and other stakeholders in mind. The Government has shown that it is prepared to listen to stakeholder feedback and amend the design of basis period reform throughout the policy development process, and the recommendations made in the Sub-Committee’s report have similarly been considered.

The aim of the Uncertain Tax Treatment regime is to reduce the legal interpretation portion of the tax gap. It will help level the playing field for large businesses by improving HMRC’s ability to identify uncertain tax treatments adopted by those that do not have an open and transparent approach, and to bring forward the point at which discussions on uncertain treatment can occur.

Overall, this is expected to result in an increase in tax revenue because it will enable HMRC to become aware of potentially incorrect tax approaches sooner than would otherwise have been the case, enabling better deployment of resources, earlier conversations and, where appropriate, earlier challenge of the approach a business has taken.

The remainder of this memorandum will address and respond to the recommendations made in the Committee’s report.

2. Basis Period Reform

***Recommendation 1**: When this work [on apportionment and estimation] is completed, but before final decisions are reached about the way forward, we recommend a reassessment of the additional compliance costs which businesses in this position will bear as a result of the reform.*

The Government accepts this recommendation.

The Government has kept the administrative and compliance costs to businesses under review throughout the policy development of basis period reform. HMRC carried out early analysis of the potential administrative costs and savings to business before the informal and formal consultations on basis period reform. This early analysis was published on 20 July 2021 in the Basis Period Reform Tax Information and Impact Note (TIIN).

HMRC developed its understanding of the administrative costs and savings to businesses through the formal consultation on basis period reform. Responses to the consultation from a range of businesses, accountants and representative bodies provided valuable information on the nature and scale of costs and savings that the reform would create. This included feedback on the specific issue of submitting tax returns including provisional figures, which respondents said could be a significant source of new administrative burdens for a small number of businesses.

Following the consultation, HMRC used this new information to update the analysis of administrative costs and savings. The results of this updated analysis were published on 27 October 2021 in an updated TIIN.

As set out in the consultation response document for basis period reform, the Government is planning to explore the issue of provisional figures with stakeholders and will consider whether and how to introduce further easements. This engagement is planned to start in late February 2022, with a decision on whether and how to introduce an easement following by autumn 2022.

Further insight into the costs to businesses of provisional figures and the administrative savings of potential easements will be gained through planned engagement with businesses and stakeholders over the coming months. After this engagement, the Government will reassess the administrative costs and savings to businesses of basis period reform under the options being considered.

***Recommendation 2**: We recommend that by 5 April 2022 HMRC should commit publicly to providing details of overlap relief from their records for those businesses that need it and, where a specific record is not available, reconstruct the amount available from the information HMRC has.*

The Government accepts this recommendation in part.

Under the current basis period rules, the complex system of double taxation followed by overlap relief does not work as intended for most of the businesses affected, as they are permanently taxed twice on the same profit. The reality of the overlap relief rules for businesses is incompatible with the Government's vision for a future tax system where people and businesses are able to pay the right tax with ease and in a more timely manner.

After discussions with businesses and accountants during the basis period reform consultation, the Government understands that some businesses may have lost records of overlap relief over time. HMRC holds data on overlap relief where a business has, at some point, reported the amount of relief it has generated on its tax return, and this data can be provided on request. The Government would like to inform businesses, if possible, of the figures that HMRC holds on overlap relief in advance of the basis period reform transition year of 2023-24.

Where HMRC does not currently hold a specific record on the amount of overlap relief carried forward, it may be possible to identify overlap periods in past years' tax returns and reconstruct a figure for overlap relief. HMRC is exploring the feasibility and resources required to provide reconstructed overlap relief figures before committing to provide these figures.

Through legislation in the Finance Bill, the Government has already extended the overlap relief provisions to ensure that businesses can use as much relief as possible on transition. This eliminates historic double taxation and ensures that all profits will only have been taxed once, creating a consistent starting point on which to introduce MTD and future reforms to the tax system.

The Government cannot commit to providing details of overlap relief and reconstructing amounts where a specific record is not available by 5 April 2022. The Government will carefully consider the timing and method of any communications on overlap relief in advance of the transition year in 2023-24, particularly for those businesses that are not represented by a tax agent or accountant.

Recommendation 3*: Our witnesses voiced a number of valid concerns about the additional tax liabilities some businesses could face on the transition to the new basis period rules, and made some suggestions about how these might be mitigated, which the Government should consider.*

The Government accepts this recommendation.

The Government has been carefully considering the impact of the transition to the new tax year basis on businesses throughout the policy development of basis period reform, and has responded to feedback from stakeholders in formulating the transition rules that have now been included in the legislation in the Finance Bill.

These updated rules ensure that the tax impact of the transition to the tax year basis is not felt in a single year; they minimise the effects of the transition on allowances and benefits while ensuring that profit is taxed appropriately; and they also ensure that businesses are able to access as much relief as possible on transition.

While the transition may result in tax timing impacts for some, the reform standardises the amount of time between profits being earned and those profits being assessed for tax. This helps to enable future reforms to assessment as well as the Government's longer-term aspirations of more real-time payment of tax and provision of support.

The Government will continue to consider feedback on the transition arrangements for basis period reform in advance of the transition to the new tax year basis.

Recommendation 4*: While noting the resources that HMRC has assigned to the implementation of this policy, we recommend that the Government and HMRC review the resources required for basis period reform and Making Tax Digital for income tax, in order to maximise the chances of a smooth implementation. In particular, we recommend specific resources should be allocated to retrieving and providing information about overlap relief to relevant businesses.*

The Government accepts this recommendation in part.

HMRC is committed to providing businesses and agents with excellent customer service and support as these reforms are rolled out in the coming years.

HMRC has considered the resources that are required to support the change to the new tax year basis, including extra support for businesses and agents, and changes to IT systems that are needed. An initial estimate of the cost to HMRC was published in the basis period reform TIIN on 20 July 2021 of between £15m and £20m. Following consultation and further exploration of the IT changes required, this estimate was revised to £13m.

As part of usual policy development processes, HMRC is keeping the implementation costs for basis period reform under review and will continue to review the estimated cost as the reform progresses, including when considering the options for easements on provisional figures. The Government therefore accepts the recommendation to review the resources required for basis period reform, as this is something that is already taking place.

The Government has also considered the resources required to successfully implement the next phases of MTD, including MTD for VAT and ITSA. These resources were included in HMRC's settlement at Spending Review 2021, and have been published in the TIIN for MTD on 23 September 2021, showing an estimated cost to HMRC for the next phases of MTD expansion at £362m.

The Government cannot yet accept the recommendation to allocate specific resources to retrieving and providing information about overlap relief, as it is still exploring the suggestions that have been made by stakeholders on supporting businesses and agents with overlap relief as set out above.

Recommendation 5*: We recommend that HMRC contacts directly all taxpayers with accounting periods which are not aligned with the tax year to alert them to the change and its implications for them and to inform them of what support is available.*

The Government accepts this recommendation in part.

The Government recognises the importance of communication with taxpayers who are affected by basis period reform and with tax agents, to raise awareness of the reform and provide information about the support that is available. However, the Government is currently considering how to ensure that this communication is timely and in the right format. We need to ensure that businesses engage with the communications about basis period reform, and that these communications come at the right time in advance of the transition year, and in advance of businesses completing tax returns for the transition year.

A number of stakeholders have offered to help HMRC in getting the communications right, particularly for unrepresented taxpayers. The Government is currently considering the most appropriate communications methods and approaches for basis period reform, and is discussing these with external stakeholders.

Recommendation 6*: HMRC should issue comprehensive guidance about basis period reform by 5 April 2022, including details of how unrepresented taxpayers can obtain support, and make a helpline number available.*

The Government accepts this recommendation in part.

The Government will be able to offer comprehensive tax guidance, including examples, covering basis period reform immediately after the Finance Bill receives Royal Assent which could come before or after 5 April 2022. Therefore the Government cannot commit to publishing guidance on basis period reform by 5 April 2022, but can commit to publishing guidance as soon as possible after Royal Assent.

The Government is considering how best to support unrepresented taxpayers through basis period reform as part of wider considerations about communications for the reform over the coming months.

A general taxpayer helpline number is available to support represented and unrepresented taxpayers through basis period reform. The extra resource needed to deal with additional queries to this general helpline has already been taken into account in HMRC's delivery cost estimates for basis period reform.

Recommendation 7*: We therefore recommend that, for those businesses which do not have a 31 March-5 April year end, Making Tax Digital should be deferred until at least 2025-26. This is also the earliest date at which partnerships – which are disproportionately represented in this group of businesses – are due to be brought into MTD. For the largest partnerships which are particularly adversely affected by basis period reform, no date for the implementation of MTD has yet been set.*

The Government does not accept this recommendation.

During the consultation on basis period reform in summer 2021, many respondents said that the reform was sensible but called for more time to implement the changes. The Government listened to these concerns, and in September 2021 announced that the original planned start date of April 2023 for the new tax year basis would be delayed by at least a year. This delay was confirmed in October 2021.

The Government also announced in September 2021 that MTD for ITSA would be introduced a year later, in the tax year beginning in April 2024. This was in response to stakeholder feedback and in recognition of the challenges faced by many UK businesses and their representatives as the country emerges from the pandemic. General partnerships will not be required to join MTD for ITSA until the tax year beginning in April 2025. The date at which all other types of partnerships will be required to join will be confirmed later. A later start for MTD for ITSA provides more time for those required to join to make the necessary preparations and for HMRC to deliver the most robust service possible, affording additional time for testing in the pilot.

The Government decided to include basis period reform legislation in the Finance Bill 2021-22 to give businesses certainty of the changes well in advance of the transition. This combination of a delayed start date and early certainty on legislation gives businesses and agents more time to understand and prepare for the change to the tax year basis and makes the transition easier for them.

Basis period reform is an essential reform to the tax system in advance of MTD, as it brings all unincorporated businesses onto a single, consistent basis of assessment aligned with the tax year and with MTD reporting. The new tax year basis charges businesses to tax on the same period that they are reporting data under MTD; without reform, the period assessed to tax could fall almost entirely outside of the MTD data reported for the tax year. Reform makes the real-time data collected under MTD much more useful and representative as it will always be aligned with the period over which the business is assessed for tax, and so better represent the business's actual tax position for the year.

Before looking at specific delays, it is important to recognise the small population affected by basis period reform – only 7% of all sole traders and 32% of partners have non-tax year basis periods, totalling 528,000 individuals. Feedback following the publication of the Finance Bill 2021-22 has indicated that many of those affected are looking to change their accounting date to align with the tax year at the same time as the basis period reform transition, reducing the number affected.

Almost half (248,000) of those affected are partners in partnerships. As the report points out, partnerships are due to be brought into MTD at least a year after the start date for basis period reform, and the largest and most complex partnerships do not yet have a date set for MTD mandation. This later MTD start date for partnerships already gives these complex businesses additional time to adapt to the new tax year basis after transition, and so they already benefit from the recommended deferral.

Looking at the remaining group of affected sole traders, not all of which will be mandated to join MTD, the recommendation would differentiate between a set of tax year aligned taxpayers drawing up accounts to 31 March – 5 April, and a set of non-aligned taxpayers. Differentiating would mean that otherwise identical businesses would see different MTD start dates solely due to their different periods of account. The current tax system essentially treats the two groups identically, as a business's choice of when to draw up accounts is not a strong enough concept to justify differential treatment. The recommended approach would also introduce the risk of businesses specifically changing their accounting date away from a simple tax year accounting date in order to delay the point at which they join MTD.

Therefore, the Government cannot accept the recommendation of different MTD start dates for some non-tax year businesses; the Government cannot justify differential treatment purely based on the date accounts are drawn up to, and such an approach could create an unintended incentive to change accounting dates.

3. Uncertain Tax Treatment

***Recommendation 8**: We recommend that, before legislating for this third trigger, an evidence-based evaluation of the measure in its current form be carried out to identify whether it does indeed deliver the benefits that HMRC tells us it is expecting. We also recommend that, if such an evaluation shows that the requirement is not delivering the benefits that HMRC expects, then the notification requirement in its entirety should be repealed.*

The Government accepts this recommendation in part.

The Government agrees that new policy measures should be monitored to ensure they are proportionate and achieve the policy objectives and expected benefits. The Government is committed to doing this for the uncertain tax treatment regime. The regime has been refined through the consultation process and the Government is therefore confident it will achieve the expected benefits but will consider the results of this monitoring carefully.

Monitoring the regime will focus on those areas which have concerned stakeholders: proportionality, administrative burden, customer service levels and achievement of the policy objective of reducing the legal interpretation portion of the tax gap.

The Government has listened to consultation feedback and responded by proceeding without the third trigger in the Finance Bill 2021-22.

The Government is keen to explore the possibility of introducing a third trigger, and will do so over the coming months through informal engagement with stakeholders. Consultations on this measure through 2021 have generated goodwill amongst stakeholders and persuaded them to engage with a Government that will listen and act upon feedback. The Government will consider a third trigger which broadens the benefits of the regime while minimising the burdens associated with the original formulation of the trigger.

While the Government agrees that monitoring is essential, it will not give a complete answer to the need for a third trigger, because the additional trigger would necessarily target uncertainties otherwise untouched by the current regime. The Government therefore intend to monitor the current regime in parallel with continuing discussions on the third trigger. Any decision to include a third trigger in a future Finance Bill would require a good understanding of the needs of large businesses alongside strong evidence it would be effective in tackling the tax gap. A third trigger will be a new policy decision for Ministers and subject to full parliamentary scrutiny and debate.

Recommendation 11*: All businesses affected by this measure must be supported appropriately by HMRC. In particular, all such businesses should have access to a customer compliance manager within HMRC with whom they can discuss uncertainties as they arise.*

The Government accepts this recommendation in part.

The Government has asked HMRC to ensure appropriate support is provided for all businesses affected by this measure, including webinars and guidance on how HMRC proposes to interpret and apply the legislation. The Government believes that businesses that do not have a customer compliance manager (CCM) should have an equivalent level of service and support as those that do, through the Mid-sized Business Customer Support Team. Both CCMs and members of the Customer Support Team have the same access to HMRC tax specialists.

HMRC will help businesses, both those with a CCM and those without a CCM, to be ready for the new requirement by providing webinars and guidance on how HMRC proposes to interpret and apply the legislation. Draft guidance was published in August 2021, and an updated version was published in January 2022. HMRC has also established a working group, involving external stakeholders, to identify and prioritise issues across tax technical guidance that require updating.

HMRC assign a senior professional called a Customer Compliance Manager (CCM) to around 2,000 businesses dealt with by their Large Business Directorate, to make sure they pay the correct amount of tax at the right time. HMRC CCMs have provided support to customers through the COVID-19 pandemic whilst continuing to fulfil HMRC's vital purpose of collecting the money that pays for the UK's public services. The latest HMRC large business survey noted that 91% of large businesses rated their overall experience with HMRC as good. The most recent customer satisfaction scores taken from the 2020 Mid-Sized Business (MSB) Annual Customer Survey stood at 65%, which is up from 58% in 2019. HMRC is committed to maintaining high levels of customer experience and meet regularly with business representatives to address any concerns.

Around 300 to 400 businesses that are dealt with by HMRC's MSB teams will be affected by Uncertain Tax Treatment. In its second consultation the Government recognised the need to ensure these businesses are not disadvantaged due to not having a CCM. HMRC will provide support for these businesses through the MSB Customer Support Team, which is a specific team dedicated to mid-sized businesses, with access to tax specialists across MSB. Having considered views expressed in the further consultation on Uncertain Tax Treatment, HMRC considers appropriate support can be provided in this way.

HMRC is able to draw on the support of tax specialists for all regimes, and can call on data analysts, solicitors, audit specialists, trade sector experts and forensic accountants. These resources are available whether the business has a dedicated CCM or not.

4. General Recommendations

***Recommendation 9**: We recommend that in future all consultations involving a significant reform of the tax system should begin at Stage 1 and invite the Government to make a renewed commitment to that effect.*

The Government does not accept this recommendation.

The Government takes consultation on tax policy seriously and, since 2010, significant improvements have been made to the tax policy making process as set out in "Tax policy making: a new approach"[1]. However, as recognised in that publication, the Government needs to take a proportionate approach to consultation on tax policies in development taking into account a range of factors depending on what is driving the need for a policy response.

Different policies will continue to require varying stages of consultation. In particular, whilst the public stages of tax consultation sometimes begin at stage 1 (call for evidence), it is common and appropriate for many consultations to begin at stage 2 (policy consultation), and this will continue to be the case.

[1] https://webarchive.nationalarchives.gov.uk/ukgwa/20130102201052/http:/www.hm-treasury.gov.uk/d/junebudget_tax_policy_making.pdf

***Recommendation 10**: We recommend that the Government commission an independent report on HMRC customer service levels and capacity. The report should separately consider HMRC's performance in terms of its existing commitments and responsibilities to taxpayers and what will be needed in terms of additional resourcing for it to be able to deliver basis period reform and MTD for income tax without any adverse effect on overall service levels.*

The Government does not accept this recommendation.

The Government does not believe that an independent report on HMRC customer service levels and capacity is required.

The Government is already transparent in relation to service levels and the steps taken to improve them. The Outcome Delivery Plan annually sets out HMRC's priorities, the strategies for achieving them and the metrics to measure success.

The Spending Review process between HM Treasury and HMRC considers the demands on the Department, including on both customer service and policy development, in order to arrive at an agreed spending settlement that will ensure HMRC has sufficient resources and capacity to be able to deliver its commitments and service levels.

Measures are designed in line with strategies to promote early engagement and provide support for all customers in getting their tax right at the outset, which is more cost effective for the Government and for customers.

HMRC have assessed the resourcing needed to deliver these policies and are confident they have the resources to meet customer service standards.